

OUR FEDERALISM IS NOT EUROPE'S. IT'S BECOMING ARGENTINA'S.

MICHAEL S. GREVE*

I. INTRODUCTION

In some ways, a 2012 symposium on “Dilemmas of State Debt” may seem a bit behind the news curve. At the end of 2010, municipal bond markets were in a deep funk. Analysts predicted that countless municipalities and perhaps one or more of the United States might default on their debt obligations. Newspapers and the blogosphere teemed with comparisons to the ongoing disaster in the European Union—if Greece could default, why not California or Illinois? Several states toughened laws dealing with insolvent municipalities, and proposals to legislate a federal bankruptcy procedure for states received considerable attention.¹

What a difference a year seems to make. Greece and other members of the Euro Zone escaped disorderly default only by a series of improvised, increasingly desperate interventions by E.U. institutions and the International Monetary Fund, and no good end to the nightmare appears in sight. In the United States, by contrast, the crisis atmosphere has abated. The city of Vallejo, California, went through bankruptcy, and municipal authorities in Birmingham, Alabama, Harrisburg, Pennsylvania, Flint, Michigan, and a handful of

* John G. Searle Scholar, American Enterprise Institute. Portions of this article are adapted from MICHAEL S. GREVE, *THE UPSIDE-DOWN CONSTITUTION* (2012). I am indebted to Alex Pollock, the participants of the Duke Law symposium for helpful comments, and to Elizabeth DeMeo, David McDonald, and Cristina Mora for excellent research assistance.

1. See, e.g., David A. Skeel, Jr., *Give States a Way to Go Bankrupt: It's the Best Option for Avoiding a Massive Federal Bailout*, 3 CAL. J. POL. & POL'Y, no. 2, 2011 at 1–5 (describing a possible state bankruptcy system); see also David A. Skeel, Jr., *States of Bankruptcy*, 2–3 (U. of Penn., Inst. for Law & Econ. Working Paper No. 11-24, 2011), available at <http://ssrn.com/abstract=1907774> (discussing a bankruptcy option for states); *State and Municipal Debt: The Coming Crisis?: Hearing Before the Subcomm. on TARP, Fin. Servs. and Bailouts of Pub. and Private Programs*, 112th Cong. (2011) (statements of Nicole Gelinas, David Skeel, Eileen Norcross, and Iris Lav) (regarding the possibility of restructuring state debt).

other places are in bankruptcy or state receivership,² but the predicted financial collapse failed to materialize. Municipal bondholders registered solid gains in 2011.³ Many states are still in dire fiscal straits, and there is wide agreement that even a robust economic recovery cannot cure their long-term, structural deficits.⁴ In that sense, the crisis continues. The risks, however, do not seem acute or systemic. For example, it seems unlikely that a fiscal collapse of Illinois or even California—with an economy many times the size of Greece and an equally dysfunctional government—could wreak havoc of European magnitude.

Even so, the strikingly different trajectories provide no cause for American “we-do-federalism-right” triumphalism. In the United States, as in Europe, subordinate governments are beset by unsustainable financial commitments. Those obligations differ in form and immediate urgency, but they share a common source: an inability on the part of the central government to maintain a credible commitment against bailing out spendthrift junior governments. That commitment was once the glory of American federalism. Over the past decade, however, the no-bailout commitment has effectively collapsed. Its demise entails fundamental changes in American federalism, none of them encouraging.

After a brief account of the transatlantic differences (Part II), this article traces the history of the anti-bailout commitment in American federalism, including its origins (Part III), erosion (Part IV), and recent collapse, as exemplified by a seemingly unrelated object of agitation, the Patient Protection and Affordable Care Act (Part V). It then compares American federalism’s emergent pathologies with Argentina’s, a federal system that exhibits them in full flourish (Part VI). The concluding part (Part VII) suggests that our political

2. Alan Farnham, *Desperate U.S. Cities Include Vallejo, Calif., Harrisburg, Pa., Central Falls, R.I.*, ABC NEWS (Sept. 8, 2011), <http://abcnews.go.com/Business/desperate-us-cities-counties-file-bankruptcy/story?id=14464314#.T0eqJ4ePUR8>; Sabrina Tavernise, *City Council in Harrisburg Files Petition of Bankruptcy*, N.Y. TIMES (Oct. 12, 2011), <http://www.nytimes.com/2011/10/13/us/harrisburg-pennsylvania-files-for-bankruptcy.html>.

3. Kelly Nolan, *Muni Bonds: A Disaster That Wasn’t*, WALL ST. J. (Dec. 23, 2011), <http://online.wsj.com/article/SB10001424052970203686204577114803651535024.html>.

4. Robert G. Ward, *State Revenues in an Era of Fundamental Change*, ROCKEFELLER INST. (Dec. 2, 2011), http://www.rockinst.org/pdf/government_finance/2011-12-02-state_revenues_ppt.pdf; see generally U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-11-495SP, STATE AND LOCAL GOVERNMENTS’ FISCAL OUTLOOK (2011), available at <http://www.gao.gov/new.items/d11495sp.pdf> (describing the growing long-term fiscal challenges of state and local governments).

institutions may no longer possess the capacity to reform our dysfunctional federalism in any meaningful way.

II. OTHER PEOPLE'S PROBLEMS, AND OURS

Start with an iron law of federalism: a system of centralized monetary and tax authority, coupled with decentralized borrowing and spending authority, is a prescription for moral hazard—that is, local over-spending and over-borrowing on the central government's credit in the hope or expectation of a federal bailout. Federal systems have coped with this menace more or less well, through a variety of techniques and institutions.⁵ But in the end, only two principal strategies are available: (1) restrict local governments' spending and borrowing authority (as the European Union is now attempting to do), or (2) establish and maintain a credible pre-commitment against bailouts.

The ability to maintain a commitment against bailouts depends on a number of factors. Just saying so, or even writing a prohibition against bailouts (as in the E.U. Treaties),⁶ is not enough; the central government must prove the commitment at least once, by letting a state go belly-up.⁷ That accomplished, the commitment must be made to last. It is a lot like virginity: one slip and it is gone for good. This dynamic operates always and everywhere. However, central governments' ability to pre-commit also depends on the structure of the subordinate governments' obligations and of the financial markets.⁸ These factors go a long way toward explaining the recent, disparate developments in the European Union and the United States.

A. *State Obligations*

Unlike Greece and many other E.U. countries, states operate (with only one exception) under balanced-budget requirements.⁹

5. See generally Jonathan Rodden, *Federalism*, OXFORD HANDBOOK OF POLITICAL ECONOMY (Barry Weingast & Donald Wittman eds., 2006) (explaining the various structures and incentives created to minimize opportunism on the part of local politicians).

6. Consolidated Treaty on the Functioning of the European Union, art. 125, 2010 O.J. (C 83/99) (ex 103 TEC) (prohibition against bailouts).

7. See generally JONATHAN RODDEN, HAMILTON'S PARADOX: THE PROMISE AND PERIL OF FISCAL FEDERALISM (2006) (analyzing the relationship between decentralization, federalism, and fiscal discipline).

8. *Id.* at 50.

9. See NCSL *Fiscal Brief: State Balanced Budget Provisions*, NAT'L ASS'N OF STATE

Admittedly, their budgets have been subject to much gimmickry and manipulation, and balanced-budget requirements have been enforced with varying degrees of stringency.¹⁰ Still, the requirements have prevented massive annual deficits on the scale of Greece, or for that matter the U.S. government, which tend to alarm the public and the markets, in turn prompting central interventions. This does not mean that states have avoided fiscal excess, only that the excess shows up in off-budget forms and places—bond obligations, and above all pension systems. For the time being, those debts seem manageable: bond debt can be rolled over (albeit at higher rates), and with the exception of a few states (such as Illinois), underfunded pension systems will not require back-breaking budget infusions for some years.¹¹ In the interim, state and local governments can do many things to address long-term problems or, more often, to muddle through: reforming pension systems,¹² paying contractors in scrip,¹³ shortening school years, closing prisons and parks, or leaving roads unrepaired.¹⁴

LEGISLATURES (Oct. 2010), <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>. (outlining states' balanced-budget requirements). The exception is Vermont. For more information on state budget requirements, see *State Balanced Budget Requirements Executive Summary*, NAT'L CONFERENCE OF STATE LEGISLATURES (Apr. 12, 1999), <http://www.ncsl.org/issues-research/budget/state-balanced-budget-requirements.aspx>.

10. Henning Bohn & Robert P. Inman, *Balanced Budget Rules and Public Deficits: Evidence from the U.S. States*, (Carnegie-Rochester Conference Series on Public Policy NBER, Working Paper No. 5533, 1996).

11. See Robert Novy-Marx & Joshua Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 191–210 (2009) [hereinafter *Liabilities*] (discussing the underfunding of state pension plans); see also Robert Novy-Marx & Joshua Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?* 66 J. FINANCE 1211, 1211–49 (2011) [hereinafter *Promises*] (discussing accurate calculation methods of public pension funds).

12. See Paul Burton, *Rhode Island Makes Reform Happen*, THE BOND BUYER (Dec. 14, 2011), http://www.bondbuyer.com/issues/120_239/rhode-island-pension-1034196-1.html (examining Rhode Island's efforts to reform its pension system).

13. See Stu Woo, *California Faces Prospect of Issuing IOUs Again*, WALL ST. J. (Aug. 18, 2010), <http://online.wsj.com/article/SB10001424052748704557704575438072401098874.html> (discussing California potentially having to pay its bills in the form of IOUs); see also Emily D. Johnson & Ernest A. Young, *The Constitutional Law of State Debt*, 7 DUKE J. CONST. LAW & PUB. POL'Y 117 (2012) (analyzing the current fiscal challenges of various state governments).

14. See Louis Freedberg & Sue Frey, *California Budget Shortfall Heightens Threat of Shorter School Year*, HUFFINGTON POST (Nov. 17, 2011), http://www.huffingtonpost.com/2011/11/17/california-budget-shortfa_n_1100194.html (describing the likelihood of California shortening its school year to save money); see also Monique Garcia, *Quinn Plans Layoffs, Facility Closings*, CHICAGO TRIBUNE, (Sep. 6, 2011), http://articles.chicagotribune.com/2011-09-06/news/ct-met-pat-quinn-illinois-budget-20110906_1_quinn-plans-major-state-employees-union-pat-quinn (discussing Illinois's cuts to social services in response to its budget shortfalls); Nicholas Johnson et al., *An Update on State Budget Cuts*, CENTER ON BUDGET & POL'Y PRIORITIES (Feb. 9, 2011), <http://www.cbpp.org/cms/index.cfm?fa=view&id=1214> (detailing budget cuts implemented in forty-six states).

America's crumbling infrastructure is a telling sign of fiscal distress and political dysfunction,¹⁵ but not the sort of thing that would trouble the credit markets.

B. Financial Markets

Before the financial crisis, the wizards who run the world's banks priced Greek debt on par with German debt, on the theory (if that is the right word) that because both countries shared a common currency, the values of their bonds should rise and fall together.¹⁶ All U.S. states and municipalities, of course, share a common currency; and yet, the markets are perfectly capable of distinguishing between Illinois bonds and Virginia bonds. Borrowing on someone else's cheap credit is what got Greece, Italy, and eventually the European Union into trouble. It is not an option for California or Illinois. Likewise, the contagion that spread through Europe seems less of a risk stateside.¹⁷ This is perplexing: one would think that the United States would feel *more* responsible for the financial fate of one of its members, and thus more bailout-prone, than the European Union.¹⁸

The most likely answer to the puzzle has to do with the structure of the debt market.¹⁹ Big banks hold most European sovereign debt. International capital requirements and accounting standards encourage those banks to load up on supposedly "risk-free" government bonds.²⁰ In addition, governments may resort to "financial repression" and *force* the banks to take on additional sovereign debt. And it is the banks—not their sovereign debtors—that are being

15. See Gene Nichol, *State Budget Challenges and the Scourge of Poverty*, 7 DUKE J. CONST. LAW & PUB. POL'Y 71 (2012) (describing the wide-ranging consequences of state budget cuts).

16. Ferry Batzoglou et al., *The Ticking Euro Bomb: How a Good Idea Became a Tragedy*, SPIEGEL (Oct. 5, 2011), <http://www.spiegel.de/international/europe/0,1518,790138,00.html>.

17. See generally Rabah Arezki, Bertrand Candelon & Amadou N.R. Sy, *Are There Spillover Effects from Munis?* (IMF Working Paper 11/290, 2011) (finding negative spillovers in U.S. municipal bond markets).

18. Randall C. Henning & Martin Kressler, *Fiscal Federalism: US History for Architects of Europe's Fiscal Union*, BRUEGEL (Jan. 10, 2012), <http://www.bruegel.org/publications/publication-detail/publication/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/>.

19. See Andrew Ang & Francis A. Longstaff, *Systemic Sovereign Credit Risk: Lessons from the U.S. and Europe*, NAT'L BUREAU OF ECON. RESEARCH (Apr. 2011), http://www.nber.org/papers/w16982.pdf?new_window=1 (arguing that systemic sovereign risk has its roots in financial markets).

20. Peter J. Wallison, *How Regulators Herded Banks into Trouble*, WALL ST. J. (Dec. 3, 2011), <http://online.wsj.com/article/SB10001424052970203833104577069911633739768.html>.

bailed out in Europe. Should one of them become insolvent, it might take the entire financial system along for a brutal ride.

State banks that serve as a source of cheap credit for their governments have been a chronic problem for many federal systems, such as Brazil (which shut down many state banks a decade ago) and Argentina.²¹ If California had a bank loaded up with the state's debt, the United States might be in Europe's position. Mercifully, however, only one of the United States, North Dakota, has such a bank.²² Overwhelmingly, state and municipal obligations are owed to bondholders and pension funds. If those debts go bad, bondholders and retirees—and probably some funds with big bets on the wrong side of the market—will have to take a haircut. That is unfortunate, but it is not a threat to the financial system. To state the crucial difference: when debts (sovereign or private) are owed to and re-leveraged by big, “systemically important” financial institutions, no central government can credibly pre-commit to a no-bailout policy. In contrast, where debts are owed to dispersed (and mostly domestic) bondholders and retirees, the central government can at least keep creditors and would-be lenders guessing.

So, no, California is not Greece. Still, not all is in good order with American federalism and its fiscal condition. Moral hazard and opportunistic behavior on the part of state and local governments are serious and growing problems. First, as already noted, states and local governments have parked their unsustainable financial commitments in their pension and retirement systems. Unfunded pension obligations are estimated to amount to upwards of three and perhaps more than four *trillion* dollars.²³ In addition, state and local

21. See RODDEN, *supra* note 7, at 208 (analyzing the relationship between decentralization, federalism, and fiscal discipline); see also Jennifer L. Rich, *A Startling Bank Privatization in Brazil*, N.Y. TIMES (Nov. 21, 2011), <http://www.nytimes.com/2000/11/21/business/a-startling-bank-privatization-in-brazil.html?ref=brazil> (discussing Santander's purchase of formerly state-owned Banco do Estado de Sao Paulo in Brazil); Mariano Tommasi, Sebastian Saiegh & Pablo Sanguinetti, *Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform*, ECONOMIA 147, 154 (2001) (describing the inefficiencies of Argentina's system of fiscal federalism).

22. See BANK OF NORTH DAKOTA, <http://banknd.nd.gov> (last visited Apr. 15, 2012) (describing the Bank of North Dakota as “the only state-owned bank in the nation”).

23. See *Liabilities*, *supra* note 11, at 191–210 (estimating unfunded obligations at \$3.23 trillion); *Promises*, *supra* note 11, at 1207–45 (estimating unfunded obligations at between \$3.2 trillion and \$4.43 trillion); see also Joshua Rauh, *The Economics of State and Local Government Finance*, FED. RESERVE BANK OF ATLANTA PUB. AFFAIRS FORUM (Oct. 26, 2011), http://www.frbatlanta.org/news/multimedia/111130_paforum_rauh_transcript.cfm (estimating unfunded liabilities at “around \$4 trillion”).

governments owe other post-employment benefits, mostly in the form of health benefits, to retirees. These obligations run north of a half-trillion dollars and are almost entirely unfunded.²⁴ Eventually, all those debts will come due. Second, while we have been spared one risk that contributed to the E.U. nightmare (big banks loaded with sovereign debt), we confront an institutional threat that the E.U. does not—a federal transfer union that combines central tax authority with local spending and borrowing authority. In many such unions, junior governments rack up unsustainable debts and central governments bail them out in one form or another.

The United States has begun to do likewise. The legislative means (described later in this article) have been partial, indirect, and subterranean. However, they have already compromised American federalism's most salutary and exceptional feature—a centuries-old federal commitment against bailouts.

III. THE COMMITMENT AGAINST BAILOUTS

The European Union's Maastricht and Lisbon Treaties contain prohibitions against bailouts of member-states by central authorities or sister-states.²⁵ The United States Constitution does not. In fact, the Constitution seems horridly deficient in stemming the bailout peril. Nothing bars states from borrowing themselves into ruin (although they must pay their debts in real money²⁶). Nothing authorizes the U.S. government to restrict the fiscal authority of even the most reckless state government.²⁷ And nothing bars the federal government from paying the states' debts, *sua sponte* or upon the states' request.²⁸ Thus, the stage seems set for irresponsible state bets on federal assistance. The scenario seems particularly likely because constitutional government in the United States *started* with a bailout—to wit, the

24. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-899, FISCAL PRESSURES COULD HAVE IMPLICATIONS FOR FUTURE DELIVERY OF INTERGOVERNMENTAL PROGRAMS 31–32 (2010).

25. Treaty on European Union, art. 103, Feb. 7, 1992, 31 ILM 247; Treaty of Lisbon, art. 123, Dec. 13, 2007, 2008 O.J. (C115) 1.

26. U.S. CONST. art. I, § 10, cl. 1.

27. See THE FEDERALIST NO. 32 (Alexander Hamilton), available at http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=788&chapter=108621&layout=html&Itemid=27 (justifying state control over state taxing and spending).

28. The narrow exception is Section 4 of the Fourteenth Amendment, which provides that “neither the United States nor any state shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States.” U.S. CONST. amend. XIV, § 4.

assumption of the states' Revolutionary War debts.²⁹ With that (arguable) exception, however, the United States has *never* bailed out a state—and not for lack of opportunity or demand. Experts have attributed this remarkable phenomenon to the federal government's “drop dead” stance in the first serious test in the years between 1837 and 1843.³⁰

A. *The Panic of 1837*

In the Antebellum Era, states competed aggressively in providing infrastructure, such as roads, harbors, and especially canals. While some funded projects through benefit taxation, others used a system of tax-free finance—state-chartered banks and internal improvement corporations sold debt instruments, very often to European investors. Those schemes sailed into trouble after a sharp deflation (a “panic,” as it was then called) in 1837.³¹ Some states, especially in the West, responded with yet more aggressive borrowing. The game was up in 1840, when banks collapsed and the bottom dropped out of the speculative land market that had supported the borrowing spree. In 1841–42, several states defaulted.

Plans for a federal bailout surfaced in 1839, well before the crisis had hit with full force. In 1843, after years of debate, a congressional committee submitted a report and proposal for federal debt assumption. The committee emphasized the dearth of state funds and available revenue sources and the danger that state defaults would halt the construction of projects that, though state-initiated, were of national, interstate importance.³² To those arguments, one could have added others. British and Dutch investors pressured the United States government for intervention, arguing (probably with some justice) that they had extended funds in reliance on the credit of the United States. In 1842, the United States was entirely cut off from international credit. Even so, and even though the federal government possessed ample tariff revenues to bankroll the states, no bailout

29. RODDEN, *supra* note 7, at 56–57.

30. See, e.g., Henning, *supra* note 18, at 10–13 (discussing Congress's refusal to pay state debts in the 1840s).

31. For a concise account of the crisis and its resolution, see RODDEN, *supra* note 7, at 58–64.

32. It also cited historical (albeit somewhat dubious) precedents. For example, the federal government had reimbursed states for expenditures incurred in the War of 1812, and a few federal subscriptions to the stock of state improvement corporations could, with some stretching, be characterized as debt relief. See RODDEN, *supra* note 7, at 58.

materialized. The committee's proposal was never even put to a vote in Congress. Lenders at home and abroad took the losses, but the credit markets soon resumed their operation. (They always do.) Scholars generally credit two subsequent developments to the 1837–43 experience: the adoption by many states of constitutional prohibitions against tax-free finance, and a firm expectation among investors and politicians that the federal government will refuse bailout demands.

B. Structure and Sectionalism

Why did the political system hold firm in 1837–43? Two factors played a central role: (1) the constitutional structure, and (2) political sectionalism.

As noted, the Constitution contains no prohibition against federal bailouts or fiscal transfers. However, in contrast to most modern federal constitutions, it also contains no “fiscal constitution”—that is, no mandate for the distribution of federal tax receipts to subordinate governments and no distributive baseline (and, as noted, no general supervisory authority over the states' taxing, spending, and borrowing decisions).³³ In the years between 1837 and 1843, “[t]hese limitations clearly bolstered the credibility of the [federal government's] commitment to stay out of the states' budget difficulties.”³⁴ The lack of a baseline deprived would-be debt relievers of a focal point and, hence, prevented them from bargaining toward a political consensus. The assumption debate was not about what distribution would be “fair” relative to a known baseline; it was about what the appropriate distribution baseline ought to be. Especially for an institutional system that demands considerably more than a simple majority in a single political body for purposes of legislation, that is usually too much to handle.

It is certainly too much to handle when states are highly heterogeneous or riven by a deep sectional divide. Again, the lessons of 1843 are instructive. The congressional committee proposed to distribute federal funds in proportion to state population. It is hard to see how that solution could have generated a consensus. The prospective payments bore no relation to individual state debt levels,

33. See generally Kenneth W. Dam, *The American Fiscal Constitution*, 44 U. CHI. L. REV. 271 (1977) (discussing and comparing Germany's Basic Law).

34. RODDEN, *supra* note 7, at 66.

let alone national interests (such as the severity of interstate spillovers) or the degree of political culpability and corruption that had produced individual states' fiscal crises. And behind those difficulties lurked the deeper, sectional problem. The "distribution in proportion to population" proposal had no constitutional warrant, but at least a reference point: the apportionment formula for direct taxes.³⁵ This, though, raised the highly explosive slavery issue.³⁶ Small wonder that bailout plans were dead on arrival.

IV. FAREWELL, MY LOVELY: FROM COMMITMENT TO THE TRANSFER STATE

The 1837–43 experience illustrates the genius of our constitutional arrangements—but also, albeit indirectly, their fragility. The constitutional baseline is what Madison called the "compound republic" and what later generations would call "dual federalism:"³⁷ bilateral (fiscal) autonomy for states and the federal government; no provision for federal transfers; no federal superintendence over state affairs. Those constitutional entitlements are the strength of the system. Their weakness is that governments may *bargain around* them. In particular, states may surrender their autonomy in exchange for federal transfer payments, and Congress may induce them to do so. These arrangements are commonly subsumed under the heading of "cooperative federalism."³⁸ They were virtually unknown during the Nineteenth Century, for the same reasons that blocked federal bailouts.³⁹ However, after a few limited and often temporary experiments with such programs during the Progressive era, the New Deal institutionalized them on a grand scale and on a permanent basis.

How and why did this happen? As noted, the commitment against bailouts sprang from two sources: the lack of a constitutional baseline

35. U.S. CONST. art. I, § 9, cl. 4.

36. It appears that the committee proposed to adhere to the three-fifths formula for counting slaves. RODDEN, *supra* note 7, at 62.

37. See THE FEDERALIST NO. 39 (James Madison), available at http://oll.libertyfund.org/?option=com_staticxt&staticfile=show.php%3Ftitle=788&chapter=108635&layout=html&Itemid=27 (discussing the compound republic); Edward S. Corwin, *The Passing of Dual Federalism*, 36 VA. L. REV. 1, 4 (1950) (explaining the concept of "dual federalism").

38. Invention of the term is generally credited to Edward S. Corwin. See generally EDWARD S. CORWIN, *THE TWILIGHT OF THE SUPREME COURT* (1934).

39. See MICHAEL S. GREVE, *THE UPSIDE-DOWN CONSTITUTION* 161–67 (2012), for a brief discussion and references.

and focal point for state bargaining, and political sectionalism. However, institutional players that are locked into a repeat game will eventually find a cooperative solution,⁴⁰ and the unusual conditions of the New Deal period—economic and social crisis, and an extraordinary degree of partisan consensus—facilitated that solution.⁴¹ Sectionalism, while greatly weakened, remained sufficiently potent to block transfer programs in policy domains where federal involvement would have posed a direct threat to the racial caste structure in the South.⁴² In most other venues, however, from poverty relief to unemployment insurance to infrastructure, the New Deal found funding formulas and institutional techniques (such as highly discretionary administrative programs) to overcome once-effective obstacles to “cooperative” transfer programs.⁴³ The remaining obstacles were eventually overcome in the 1960s, with the creation of federal education programs and Medicaid under the Great Society.

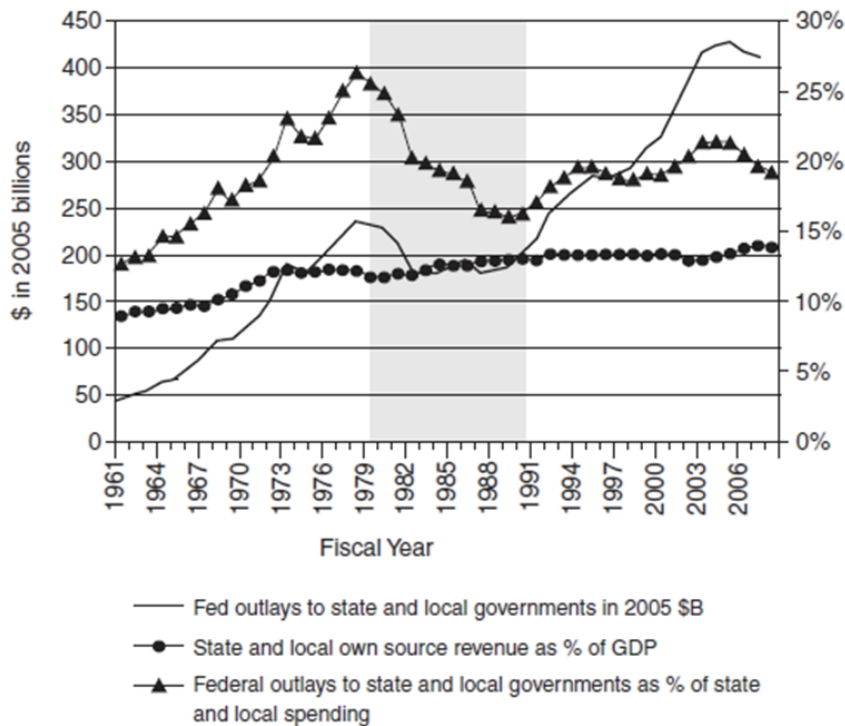
Cooperative transfer programs have four effects, well-recognized in a voluminous “fiscal federalism” literature, that bear on the commitment against bailouts, state and local indebtedness, and the fiscal and institutional future of our federalism. First, transfer programs inflate the demand for government at all levels (national, state, and local). Second, they support local political elites and their clientele, especially public-sector unions. Third, they produce acute moral hazard—that is, state and local overspending and gambling on a federal bailout. Fourth, they have potent self-reinforcing tendencies. The chart below illustrates some of those effects.

40. Game theorists call this well-established proposition the “folk theorem” because nobody seems to have discovered it first. See Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting or with Incomplete Information*, 54 *ECONOMETRICA* 533 (1986) (describing the “folk theorem”).

41. See Jenna Bednar, William N. Eskridge, Jr. & John Ferejohn, *A Political Theory of Federalism*, *CONSTITUTIONAL CULTURE AND DEMOCRATIC RULE* 223 (John Ferejohn et al. eds., 2001), for a similar account.

42. See generally FRANK J. MUNGER & RICHARD F. FENNO, JR., *NATIONAL POLITICS AND FEDERAL AID TO EDUCATION* (1962) (identifying education as the primary example of sectionalism’s constraints on transfer programs).

43. RICHARD FRANKLIN BENSEL, *SECTIONALISM AND AMERICAN POLITICAL DEVELOPMENT, 1880–1980*, 175–255 (1984). Bensel emphasizes two institutional factors that stabilized the system: a congressional committee system that was able (until the 1960s) to bottle up legislation that might have broken the bipolar New Deal coalition, and an administrative apparatus with discretionary means and budgetary resources to negotiate sectional (and thus political, intraparty) conflicts.



Fiscal federalism trends, 1961–2008. Sources: GDP: U.S. Department of Commerce, Bureau of Economic Analysis (available online at <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N>); federal spending: U.S. Federal Budget (<http://www.gpoaccess.gov/usbudget/fy11/hist.html>); state and local data: U.S. Census Bureau (<http://www.census.gov/govs/estimate/>). The Rockefeller Institute of Government graciously provided a compilation of this data.

Chart taken from THE UPSIDE-DOWN CONSTITUTION⁴⁴

A. *More Government*

Transfer programs inflate the demand for government by reducing its perceived cost.⁴⁵ Almost certainly, this fiscal illusion has driven the

44. GREVE, *supra* note 39, at 273.

45. Suppose that state taxpayers would refuse to pay \$100 for some redistributive program. Then suppose that the federal government offers to chip in \$50 for every \$50 spent by the state on that same program: taxpayers may well support the scheme, failing to recognize that the federal government's share is also their tax responsibility.

growth of government in the United States. From the end of the Korean War to the 2008–09 financial crisis, federal revenue as a percentage of gross domestic product hovered within a narrow eighteen to twenty percent range. The state and local share, in contrast, rose from roughly six percent (not shown in the chart) to almost fifteen percent. In fiscal terms, the growth of government over the past half century is principally attributable to the growth of state and local government.

B. E Pluribus Unions

Cooperative federalism and transfer programs respond to the national-level weakness of redistributive coalitions in American politics. Because direct redistribution often encounters public resistance, politicians either disguise programs as a form of (middle-class) self-insurance, as with Social Security or Medicare, or else mobilize state governments, bureaucracies, and their clientele in support. Education programs support educators (and children only secondarily); Medicaid supports providers; and so on. Economists estimate the ratio of this diversion or “flypaper effect”—the money sticks where it hits—at somewhere between 0.3 and 1.0.⁴⁶

C. Moral Hazard

Over time, federal transfer programs increase moral hazard. In large measure, this is a function of state and local officials’ constricted time horizon. Officeholders aggressively seek federal funding—a benefit that accrues during their expected tenure in office—even if the long-term fiscal consequences for the state are known to be ruinous. The perceived benefits (transfers) have electoral consequences; the real long-term costs generally do not.⁴⁷

D. Self-Enforcement

Transfer programs are self-enforcing in that no institutional player can defect without making itself worse off. No state can opt out without leaving its taxpayers’ proportional contribution to the federally financed program on the table; and the more generous the federal program, the more difficult a state will find it to replace

46. Robert P. Inman, *The Flypaper Effect* 1 (Nat’l Bureau of Econ. Research, Working Paper No. 14579, 2008), available at <http://ssrn.com/abstract=1320825>.

47. See *infra* Part VII.B for a discussion of the possible limiting condition, an acute recognition among voters that debt levels have become unsustainable.

federal dollars with other revenues. Moreover, potent local bureaucracies and political constituencies (such as public-sector unions or healthcare providers) typically support transfer programs, creating an additional lock-in effect.⁴⁸ Federal legislators, for their part, generally prefer a “cooperative” transfer program to the alternatives of either wholesale nationalization or federal repeal.⁴⁹

Over time, transfer programs drive up local taxing and spending. They crowd out unfunded programs—that is to say, things that state and local governments have to pay for from own-source revenues. (This is why Medicaid, the most generous federal program, has come to consume over twenty percent of the states’ budgets.⁵⁰) When state revenues hit a wall, local programs have been cut to the bone. Federally funded programs cannot be cut without leaving money on the table, so states hide the shortfalls off-budget by underfunding their pension programs. “Cooperative federalism” creates this dynamic. How does it respond to its own self-destructive tendencies?

The decline in federal outlays to states during the “Reagan Revolution,” shaded in gray in the chart above and briefly discussed below, suggests that cooperative federalism may be capable of reform and retrenchment. Note, though, that cooperative federalism quickly emerged from the Reagan era and resumed its upward march. The ascent is marked by increasingly desperate measures to shore up a dysfunctional system.

The first response to the transfer state’s nasty state-level fiscal effects is to make federal programs more generous. Between the end of the Second World War and 1980, that strategy was made possible by inflation;⁵¹ in the 1990s, by the dissipation of the “peace dividend”; and since then, by accumulating federal debt. For reasons mentioned, however, rolling debt relief only exacerbates the states’ fiscal travails. The next move is to enact partial, de facto bailouts under different

48. This is a common explanation for the asymmetrical effect of federal transfer programs. See generally SHAMA GAMKHAR, *FEDERAL INTERGOVERNMENTAL GRANTS AND THE STATES: MANAGING DEVOLUTION* (Edward Elgar Publ’g Ltd. ed., 2002) (extensively discussing the additional lock-in effect of federal transfer programs).

49. This generalization holds true regardless of federal legislators’ ideology or partisan affiliation.

50. NAT’L ASS’N OF STATE BUDGET OFFICERS, *STATE EXPENDITURE REPORT EXAMINING FISCAL 2009–2011 STATE SPENDING* 3 (2011), available at <http://www.nasbo.org/sites/default/files/2010%20State%20Expenditure%20Report.pdf>.

51. John J. Wallis, *The Political Economy of New Deal Fiscal Federalism*, 29 *ECON. INQUIRY* 510, 524 (1991), available at <http://search.proquest.com/docview/200985434>.

names.

The political landscape is littered with such measures, even if their true nature is rarely acknowledged. Unsurprisingly, some bailout measures were temporary responses to the financial crisis that began in 2008. For example, the federal government created Build America Bonds, effectively subsidizing well north of \$78 billion in newly issued municipal bonds by paying thirty-five percent of the interest.⁵² For another example, the American Recovery and Reinvestment Act (ARRA), better known as the 2009 “Stimulus” bill, provided some \$223 billion to state and local governments. Roughly half of the amount was dedicated to program- and project-specific transfers, principally for the purpose of propping up the government employment market.⁵³

With some effort, one can describe these programs as anti-cyclical macro-economic initiatives rather than bailouts. Consistent with that riff, some programs have been discontinued as the economy has recovered sufficient breath to fog a mirror. Build America Bonds were allowed to expire at the end of 2010. A temporary increase in Medicaid’s Federal Medical Assistance Percentages (FMAP), originally contained in ARRA, was extended until July 2011 when it, too, was allowed to expire. Still, ARRA’s dominant effect was to close state budget gaps;⁵⁴ and in any event, de facto bailouts long predate the financial crisis.

Predictably, those measures were concentrated in Medicaid, the biggest and most generous transfer program and, consequently, the chief contributor to the states’ fiscal woes. Under the Clinton administration, for example, Congress enacted a children’s health insurance program (CHIP) that, while principally intended to provide insurance to uninsured children, also provided states with the opportunity—and a powerful incentive—to reassign Medicaid-covered children from that overburdened program into the more generously funded CHIP program. More recently, Congress enacted the already mentioned FMAP increases. Those measures, however, pale in comparison to the biggest bailout measure to date—the 2011

52. Ianthe Jeanne Dugan, *Build America Pays Off on Wall Street*, WALL ST. J. (Mar. 10, 2010), <http://online.wsj.com/article/SB10001424052748704869304575104101463410466.html>.

53. Robert P. Inman, *States in Fiscal Distress*, FED. RESERVE BANK OF ST. LOUIS, 6 REGIONAL ECON. DEV. 65, 66 (2010), available at <http://research.stlouisfed.org/publications/red/2010/01/Inman.pdf>.

54. *Id.*

Patient Protection and Affordable Care Act.

V. A CASE STUDY IN FEDERALISM ADJUSTMENT: THE AFFORDABLE CARE ACT

By any measure, the Patient Protection and Affordable Care Act (ACA)⁵⁵ is the most consequential and controversial piece of legislation enacted in several decades. It also constitutes a major federalism adjustment: it builds on cooperative federalism's most dysfunctional features, and doubles down.

The ACA's crucial federalism innovation is not the much-maligned, intensely litigated "individual mandate"—that is, the provision that uninsured individuals, beginning in 2014, must either purchase health insurance or else pay a fiscal penalty.⁵⁶ Regardless of the individual mandate's fate in the Supreme Court, two other parts of the ACA will have far greater effects on the healthcare and health-insurance systems and, more broadly, on American federalism. One of them is a massive expansion of Medicaid;⁵⁷ the other, the establishment of state-run health-insurance "exchanges" for individuals and small businesses.⁵⁸

Originally enacted in 1965, Medicaid is a "cooperative" federal-state program. If a state agrees to provide medical services for certain populations, the federal government reimburses between fifty and eighty-three cents of each dollar spent on the service.⁵⁹ The match, or FMAP, depends on the state's wealth, with poor states receiving higher matches. For participating states, coverage of certain populations and services is mandatory. However, states may voluntarily cover additional populations and services. All have done so to varying degrees. The ACA builds on this regime. Beginning in 2014, it requires participating states to cover all individuals up to

55. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified in scattered titles of 21, 25, 26, 29 and 42 of the United States Code) [hereinafter ACA].

56. *Id.* § 1311, 124 Stat. at 173–81.

57. *See id.* § 2001–2955 (expanding Medicaid coverage as well as other programs).

58. *See id.* § 1311(a), 124 Stat. at 173 (establishing health-insurance exchanges).

59. MEDICAID AND CHIP PAYMENT AND ACCESS COMM'N, REPORT TO THE CONGRESS ON MEDICAID AND CHIP 38 (Mar. 2011), available at https://a7d050c2-a-10078ef1-s-sites.googlegroups.com/a/macpac.gov/macpac/reports/MACPAC_March2011_web.pdf. For a general overview of Medicaid's history and recent developments, see U.S. SOC. SEC. ADMIN. OFFICE OF RET. AND DISABILITY POLICY, ANNUAL STATISTICAL SUPPLEMENT 2011 56 (2011), available at <http://www.ssa.gov/policy/docs/statcomps/supplement/2011/supplement11.pdf>.

133% of the federal poverty line.⁶⁰ The expanded program is expected to provide health coverage for an additional sixteen million poor and near-poor—heretofore uninsured—individuals at a cost of upwards of \$500 billion between 2014 and 2019.⁶¹

For uninsured individuals outside Medicaid's ambit and for small businesses, the ACA envisions the establishment of state-run, federally superintended "health benefit exchanges."⁶² (In states that fail to establish such exchanges, the U.S. Department of Health and Human Services (HHS) will do so directly.⁶³) The federal government will provide substantial subsidies for insurance obtained through—but not outside—an exchange. The exchanges are also the vehicles through which the ACA's complicated requirements concerning coverage, reimbursement rates, and the like will be enforced.

For present purposes, two features of the ACA's convoluted architecture merit attention. First, the Medicaid provisions are the latest and biggest step in a series of rolling bailouts. The federal government will pay 100% of the costs for the "new eligibles."⁶⁴ The ratio will gradually decline to ninety-three percent by 2019.⁶⁵ Even so, the ACA will add at most two or three percent to the Medicaid costs that the states would have incurred in any event.⁶⁶ For most states, moreover, the ACA translates into a substantial increase of the average FMAP. Texas, for example, will see its match increase from roughly sixty to seventy percent.⁶⁷

Second, the ACA—once it is fully operational—will allow states to transfer hundreds of thousands of current and former employees and their healthcare expenses from state-funded programs either into

60. ACA § 2001, 124 Stat. at 271.

61. KAISER COMM'N ON MEDICAID AND THE UNINSURED, MEDICARE MANAGED CARE: KEY DATA, TRENDS AND ISSUES (2012), *available at* <http://www.kff.org/medicaid/upload/8046-02.pdf>.

62. ACA § 1311(a), 124 Stat. at 173.

63. *Id.* § 1321.

64. *Id.* § 2001(a)(3).

65. *Id.*

66. JOHN HOLAHAN & IRENE HEADEN, KAISER COMM'N ON MEDICAID AND THE UNINSURED, MEDICAID COVERAGE AND SPENDING IN HEALTH REFORM: NATIONAL AND STATE BY STATE RESULTS FOR ADULTS AT OR BELOW 133% FPL 6 (2010), *available at* <http://www.kff.org/healthreform/upload/Medicaid-Coverage-and-Spending-in-Health-Reform-National-and-State-By-State-Results-for-Adults-at-or-Below-133-FPL.pdf>.

67. EVELYN P. BAUMRUCKER, CONG. RESEARCH SERV., RL 32950, MEDICAID: THE FEDERAL MEDICAL ASSISTANCE PERCENTAGE (FMAP) 16 (2010), *available at* <http://aging.senate.gov/crs/medicaid6.pdf>.

Medicaid or into the health-benefit exchanges.⁶⁸ The magnitude of this effect is impossible to predict. It is largely a function of HHS's implementation of the ACA, which is now and forever shall be a poorly constrained work in progress. One can safely predict, however, that state politicians and bureaucracies will lobby aggressively for transfer-facilitating regulations. HHS will be hospitable to their entreaties; it needs the states, both to provide political support for the implementation of the program and to make the unwieldy exchanges work.

Like much of the ACA, a large-scale federal takeover of state and local obligations incurred in peacetime would be unprecedented in U.S. history. Other federal systems, however, have resorted to such measures. Once proud and productive Argentina provides a particularly apt comparison.

VI. WELCOME TO ARGENTINA?

Like the United States, Argentina is a presidential, federal, and bicameral system. It features a large number of states (provinces) and a powerful, poorly apportioned upper house (the Senate).⁶⁹ Its Nineteenth-Century constitution is modeled on the U.S. Constitution and, prior to 1994 amendments that, in atonement for the country's authoritarian sins, domesticated the international non-governmental-organization agenda (e.g., the protection of women during lactation),⁷⁰ resembled ours in often striking detail. Argentina's federalism, like ours, was profoundly "dual" until the mid-Twentieth Century when it succumbed, like ours, to a "cooperative" mode of operation.⁷¹ Argentina has since become something of a poster child for fiscal federalism's dysfunctions.⁷² Provinces gamble on federal bailouts; go bust; are taken over by federal officials; and, following a brief interregnum, promptly revert to their exploitative form.

68. Philip Bredesen, *Obamacare's Incentive to Drop Insurance*, WALL ST. J. (Oct. 21, 2010), <http://online.wsj.com/article/SB10001424052702304510704575562643804015252.html>.

69. For a brief overview of Argentina's government, see Antonio M. Hernandez, *Republic of Argentina*, LEGISLATIVE, EXECUTIVE, AND JUDICIAL GOVERNANCE IN FEDERAL COUNTRIES 8 (Katy le Roy & Cheryl Saunders eds., 2006), available at <http://www.federalism.ch/files/categories/IntensivkursII/Argentinag3.pdf>.

70. See CONSTITUCION NACIONAL DE LA REPUBLICA ARGENTINA art. 75, § 23, available at <http://pdba.georgetown.edu/Constitutions/Argentina/argen94.html> (protecting human rights, especially of children, women, the aged, and the disabled).

71. Hernandez, *supra* note 69, at 2.

72. Tommasi et al., *supra* note 21, at 157.

To be sure, the differences between Argentina's federalism and ours remain stark and meaningful. One difference is economic: Argentina, a century ago among the richest, most developed nations, has since suffered long-term decline, broken by intermittent, often hectic and inflationary, growth spurts.⁷³ A second difference is Argentina's political instability. The country's periodic lurches into authoritarianism and insolvency are closely connected to a federalism that has produced overspending, opportunistic subnational "rentier states," and a central government unable to stem subordinate governments' recklessness.⁷⁴

Occasional suggestions to the effect that America is approaching *that* sort of political predicament⁷⁵ probably have more to do with the air in New Haven than with any basis in fact. Quite arguably, however, American federalism has begun to develop some of the fiscal and institutional dysfunctions on full display in Argentina. Two are particularly suggestive: the emergence of an "executive federalism," and federal bailouts embodied in pension reform.

A. *Executive Federalism*

In the 1930s, Argentina's provinces did what American states have never done: they surrendered their constitutional tax autonomy to the central government. As a result, Argentina suffers an extreme vertical fiscal imbalance—that is, a highly centralized system of tax collection, coupled with highly decentralized spending (and borrowing) authority and an extravagantly large system of federal transfers. Over sixty percent of provincial budgets consist of federal transfers; in ten provinces, the amount is over eighty percent.⁷⁶ Under a system of general revenue sharing, funds reach provincial governments with no strings attached. The system, however, has been perennially beleaguered; a general reform, though promised in a 1994

73. JORGE P. GORDIN, INSTITUT BARCELONA D'ESTUDIS INTERNACIONALS, THE POLITICS OF INTERGOVERNMENTAL FISCAL RELATIONS IN ARGENTINA 4 (2006), *available at* http://www.tkp2e-dak.org/Dokumen/kajian/WP_IBEI_2.pdf.

74. *See generally* Carlos Gervasoni, *Fiscal Federalism as a Source of Rents* (Am. Pol. Sci. Ass'n, Meeting Paper, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1450202#%23 (describing fiscal federalism rents, using Argentina as an example); *see also* GORDIN, *supra* note 73, at 4 (assessing the explanatory power of two different views on subnational fiscal relations).

75. *See, e.g.*, BRUCE ACKERMAN, THE DECLINE AND FALL OF THE AMERICAN REPUBLIC (2010) (arguing that numerous American political institutions and practices produce a culture of lawlessness).

76. Tommasi et al, *supra* note 21, at 161.

constitutional revision, has never materialized.⁷⁷ Very often, transfers are haggled out in “fiscal pacts” between provincial governments and the national executive. Those pacts are driven not so much by substantive economic rationality but by political demands and forces, such as the executive’s protection of a political-power base and the provinces’ bargaining strength.⁷⁸

The U.S. Congress is far more assertive *vis-à-vis* the executive than the Argentinian legislature. It seems unlikely that it would consent to executive-led fiscal pacts, or that individual states would voluntarily lock themselves into global fiscal bargains with the federal government (if for no better reason than that there is no single federal agency with whom such a deal could be negotiated). Unmistakably, however, American federalism has been lurching in the direction of executive federalism on a program-by-program basis.

The principal example, again, is Medicaid. Under this program, representing over forty percent of all federal transfer payments to state and local governments, the vertical fiscal imbalance—as measured by the FMAP—has already reached Argentinian proportions. The ACA will further promote that tendency. Moreover, the U.S. Congress has deliberately put itself into the position of the Argentinian legislature. Under the statute, Congress will write a blank check for whatever the federal match for the states’ programs may turn out to be. The contours of state programs, in turn, are haggled out between a federal bureaucracy endowed with ample discretionary and waiver authority and individual states that vary widely with respect to both local spending demands and their propensity and ability to game the system.

Further, the ACA couples its massive Medicaid expansion with a system of state-run but federally subsidized and superintended health-benefit exchanges. These arrangements, too, are largely a matter of poorly constrained, individualized federal-state bargains.⁷⁹ It

77. *Id.* at 162.

78. *Id.* at 175–85 (describing the Political-Transactions Theory, which explains features of public policies as the outcomes of political transactions).

79. See, e.g., Secretary Kathleen Sebelius, *Empowering States to Innovate*, THE WHITE HOUSE BLOG (Feb. 28, 2011, 11:56 AM), <http://www.whitehouse.gov/blog/2011/02/28/empowering-states-innovate>; Press Release, U.S. Dep’t of Health & Human Servs., Obama Administration Takes New Steps to Support Innovation, Empower States (Mar. 10, 2011), available at <http://www.hhs.gov/news/press/2011pres/03/20110310a.html>; Press Release, U.S. Dep’t of Health & Human Servs., HHS Secretary Sebelius Announces New Pre-Existing Condition Insurance Plan, (July 1, 2010), available at <http://www.hhs.gov/news/press/>

is no exaggeration to say that healthcare and insurance—a very large swath of the U.S. economy and of the business of government—has been effectively Argentinianized.⁸⁰

B. *Pensions*

Unsustainable state and local pension obligations are a central issue in Argentina as well as the United States, for substantially identical institutional reasons (state or provincial governments' misaligned incentives). As for the United States, it is a foregone conclusion that state and local governments' obligations will not be paid in full: they *cannot* be paid. Forward-looking measures—for example, a move from defined-benefit plans to 401(k)-style plans for new state and local employees—can delay but not avert the day of reckoning, when somebody must cut the existing entitlements and abrogate the contractual obligations. The question is how the political system will administer the haircut, and to whom.

One possible U.S. model is the existing Pension Benefit Guaranty Corporation (PBGC), whose member-companies contribute to a common fund dedicated to paying the pension obligations owed by other, bankrupt companies.⁸¹ It is unlikely, however, that responsible states and their pension funds would agree to such a scheme; and, unlike public companies, they cannot be *forced* into it as a constitutional matter. Moreover, the PBGC's perilous financial state diminishes its attraction.⁸²

Argentina provides a different, more plausible (although not necessarily more attractive) model. First, in 1994, the central government rolled the pension programs of eleven provinces—outstanding obligations, contributions, and all—into a recently reformed (but soon-to-be troubled) federal pension system.⁸³ The cost of this bailout was initially estimated at \$500 billion; the actual cost

2010pres/07/20100701a.html.

80. By some indications, K-12 education has begun to conform to the same pattern. *See, e.g.*, Press Release, U.S. Dep't of Educ., President Obama: Our Children Can't Wait for Congress to Fix No Child Left Behind, Announces Flexibility in Exchange for Reform for Ten States, (Feb. 9, 2012), *available at* <http://www.ed.gov/news/press-releases/president-obama-our-children-cant-wait-congress-fix-no-child-left-behind-announces-flexibility-exchange-reform-ten-states>.

81. Pension Benefit Guaranty Corporation, 29 U.S.C.A. § 1302 (West 2006).

82. Dan Kadlec, *Pension Backstop Posts Record Shortfall. Is a Bailout Next?* TIME MONEYLAND (Nov. 17, 2011), *available at* <http://moneyland.time.com/2011/11/17/pension-backstop-posts-record-shortfall-bailout-next>.

83. Tommasi et al., *supra* note 21, at 160.

proved three times that amount.⁸⁴ Second, the government declared that the obligations would be payable not (as originally promised) in U.S. dollars but in Argentinian pesos. The devaluation amounted to roughly thirteen percent of outstanding obligations.⁸⁵

Could this happen in the United States? The scheme seems needlessly complicated; we could simply peso-ize the U.S. economy and inflate state and local debts away along with everyone else's.⁸⁶ At the same time, a *global* federalization of state and local pensions seems very unlikely. Large groups of state and local employees, such as police officers and firefighters, are firmly entrenched at the local level, while lacking a federal "go-to" agency that would tend to their demands. They will consent to federalization only as a last resort and as an alternative to an otherwise certain benefit cut. One can, however, imagine an Argentinian solution for other parts of the state and local workforce, such as educational personnel and perhaps transit workers. Teachers in particular have a muscular presence in Washington, D.C., and a federal agency (the U.S. Department of Education) that sees to their concerns. Existing statutes, moreover, already regulate their workplace entitlements in considerable detail.⁸⁷ A quality education for all children, the argument runs, requires highly skilled and motivated teachers. Such teachers, though, cannot be attracted or retained if their retirement benefits are in perennial doubt. Accordingly, the argument continues, states participating in federal education programs must either guarantee and fully fund those benefits in perpetuity, or opt into a federal pension system. A "Teacher Retention Act" along these lines could roll up to nine million state and local employees into an Argentinian system.⁸⁸ It would not break with any principle or premise of our federalism.

84. For a concise description, see Fabio M. Bertranou, Carlos O. Grushka and Rafael Rofman, *From Reform to Crisis: Argentina's Pension System*, 2 INT'L SOC. SECURITY REV. 103, 107 (2003).

85. *Id.* at 108.

86. Some prominent economists have come to advocate this policy, principally on the grounds that no other solution is in sight. See, e.g., Kenneth Rogoff, *The Second Great Contraction*, PROJECT SYNDICATE (Aug. 2, 2011), available at <http://www.project-syndicate.org/commentary/rogoff83/English>.

87. No Child Left Behind Act of 2001, Pub. L. No. 107-110, § 1119 (2002).

88. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, CAREER GUIDE TO INDUSTRIES, 2010-11 EDITION (2009), available at <http://www.bls.gov/oco/cg/cgs034.htm>.

VII. REFORM?

The fundamental fiscal federalism dilemma is between a credible central commitment against bailouts and central control over subordinate governments' fiscal affairs. That dilemma marks the state of our federalism. On one side, the commitment has been severely compromised. On the other side, central fiscal controls have their limits—we are not going to see states in de facto receivership, either under a bankruptcy judge or, as in Argentina and more recently in Europe, under centrally approved and installed emergency governments. The United States has resorted to that extra-constitutional strategy only once, during Reconstruction; it is not about to do so again. Too many constitutional, institutional, and political obstacles stand in the way. That leaves two scenarios. One is an accelerating series of increasingly aggressive bailouts-by-any-other-name, with increasingly Argentinian overtones and effects. The other is a contraction of the transfer state and a step back into a more “dual” federalism—that is, a wholesale nationalization of “cooperative” federal-state programs, or else a wholesale devolution of responsibility, *including tax and funding authority*, to state and local governments.

The general consensus among experts is that federal systems will contemplate reforms of this sort only under extreme conditions and in response to severe shocks.⁸⁹ (In normal times, fiscal federalism's pathological, self-enforcing tendencies will prevail.) As noted earlier, our fiscal federalism encountered such a challenge once, under the first Reagan Administration. A brief review of that experience prompts probing questions about federalism's current condition and likely trajectory. The answers are far from comforting.

A. *Failed Reform*

In the early 1980s, cooperative federalism encountered a twofold shock: the Federal Reserve Board's decision to wring inflation out of the economy, which ended the political strategy of redeeming promises to state and local governments in cheaper dollars;⁹⁰ and the collapse of a formerly stable political consensus on cooperative

89. See generally RODDEN, *supra* note 7, ch. 8 (explaining “why states, under conditions of an integrated and highly mobile economy, would opt for the New Deal Constitution's federalism”).

90. John J. Wallis, *The Political Economy of New Deal Fiscal Federalism*, 29 ECON. INQUIRY 510, 512–15 (1991).

federalism, which prompted an ambitious “New Federalism” initiative by the newly elected Reagan Administration.⁹¹ The core of this initiative was a proposal, based on expert recommendations (mostly from the Brookings Institution), to disentangle cooperative federalism by means of a welfare “swap”: the federal government would assume full funding responsibility for Medicaid and food stamps in exchange for the states’ assumption of full responsibility—including *revenue responsibility*—for AFDC and other welfare programs.⁹² The swap was carefully calculated to improve the fiscal condition of all states, both on a current and prospective basis (as Medicaid payments were growing much faster than welfare obligations). Its central assumption was that perennial state complaints over “unfunded mandates,” onerous grant conditions, and deteriorating state finances would translate into state support for disentanglement on fiscally advantageous conditions.

That assumption proved gravely mistaken. Neither state officials nor the welfare lobby were remotely prepared to entertain the swap proposal, and it was never even introduced in Congress. Confronted with the states’ and their clientele’s vehement protests, the Reagan Administration abandoned its disentanglement objective and instead endeavored to stem the flow of federal money to state and local governments—as shown in the graph above, with notable but transitory success. Statutory mandates soon proliferated again, and transfer payments (especially for Medicaid) resumed their growth.

B. Better Luck this Time?

Can one imagine a more successful challenge to cooperative federalism under current conditions? Some factors point in that direction. For one thing, fiscal federalism has reached the outer limits of its plausibility. Its point is to create fiscal illusions. The ACA’s match of 100 cents on the dollar, by way of contrast, is not an illusion: federal taxes-plus-debt match expenditures. Similarly, state and local taxes have been stuck at roughly fifteen percent of gross domestic product since the end of the Reagan years, which suggests that cooperative federalism may have lost its capacity to spur local tax

91. TIMOTHY J. CONLAN, FROM NEW FEDERALISM TO DEVOLUTION: TWENTY-FIVE YEARS OF INTERGOVERNMENTAL REFORM, 191–211 (1998) (describing regulatory federalism under President Reagan).

92. *Id.* at 182.

efforts.⁹³ If that is so, cooperative federalism's further expansion will require some combination of yet-more-generous transfers and off-budget state debt, neither of which seems sustainable. Finally, state politicians' time horizon and incentives may have become more closely aligned with the electorate's sentiments and calculations. Take-the-money-and-run-for-higher-office is a rational strategy only so long as voters remain ignorant of the long-term costs (or discount them at fantastic rates). Recent gubernatorial refusals to accept federal funds for high-speed train systems suggest that the calculus may have changed⁹⁴—perhaps, because voters suspect that a debt-ridden federal government will fail to make good on its commitments.

Against these considerations stand profound and dispiriting changes in American politics. Reagan's New Federalism reflected a broad political consensus (among the electorate, policymakers, and experts) that cooperative federalism had failed to work and that something could and should be done about it.⁹⁵ That is no longer so. Public distrust of political institutions is running at record levels, but the cynicism has not translated into any coherent agenda. We seem to take it for granted that our institutions will fail us.⁹⁶ At the same time, broad dissatisfaction with cooperative federalism has given way to bipartisan support. Democrats recognize, more keenly than three decades ago, that the transfer state is the party's backbone—it sustains both the recipients and, more importantly, the (unionized) distributors of federal-state largesse. Republicans, for their part, have gotten much dumber. The GOP's federalism Plan B, after the failure of the Reagan agenda, was “devolution”—that is, the reconfiguration of cooperative transfer programs on terms that are more acceptable to state officials.⁹⁷ The supposed crown jewel of that agenda is the 1996 welfare reform,⁹⁸ which granted states vastly increased discretion

93. See GREVE, *supra* note 39, at 273 (including a graph showing state and local own source revenue as a percentage of gross domestic product).

94. See, e.g., Vauhini Vara, *California Train Plan Hits Bump Over Funds*, WALL ST. J., Jan. 4, 2011, at A2.

95. CONLAN, *supra* note 91, at 141–43.

96. For evidence of this growing cynicism and distrust of government, see AM. ENTER. INST., HOW DO AMERICANS FEEL ABOUT THEIR GOVERNMENT? AN AEI PUBLIC OPINION REPORT (Dec. 2010), available at <http://www.aei.org/press/politics-and-public-opinion/polls/how-do-americans-feel-about-their-government-an-aei-public-opinion-report>.

97. For brief discussion and references, see Michael S. Greve, *Against Cooperative Federalism*, 70 MISS. L.J. 557, 582 (2000).

98. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193.

in configuring their welfare systems. The notion that this reform constitutes a plausible conservative federalism model is nine parts self-delusion and one part snake oil. States converted formerly mandatory cash payments to welfare recipients into wages for state bureaucrats who run education programs, pregnancy management, drug rehabilitation, and other “workfare” requirements.⁹⁹ At the same time, federal cash transfers and their equivalents exploded under programs outside welfare (such as food stamps and housing subsidies), to the point where welfare is often preferable to work.¹⁰⁰ Any block grant will increase the potential for similar opportunistic state behavior. Even so, the devolution agenda still unites Republicans from the Tea Party to Mitt Romney supporters, and the will to rethink that agenda is nil. Thus, our polarized politics converges on a 1960s-ish consensus: cooperative federalism has not failed. It has never been tried.

Things that cannot go on, the late Herbert Stein remarked, will eventually end.¹⁰¹ Our federalism cannot go on. Eventually, the debts will hit home. Eventually, the dollar will lose in the currency markets’ ugly dog contest. Eventually, one hopes, American government and federalism will revert to constitutional roots. However, Professor Stein’s sagacious pronouncement is of doubtful relevance to the conduct of political affairs. As Thomas Hobbes taught, the fear of death never prompts individual action: death is certain, and fear of it is a constant. People learn to live with it and with the loss of vitality along the way. What sparks action is fear of a *sudden and violent* death.¹⁰² The same may be true of political systems, including our federalism. It faces no imminent collapse; and because it does not, it may be destined for an Argentinian fate.

99. Douglas J. Besharov, *Two Cheers for Welfare Reform*, AEI ON THE ISSUE (Aug. 2006), available at <http://www.welfareacademy.org/pubs/welfare/twocheersforwelfarereform.pdf>.

100. Douglas J. Besharov and Douglas M. Call, *Income Transfers Alone Won’t Eradicate Poverty*, 37 POL’Y STUD. J. 599, 600 (2009), available at <http://www.welfareacademy.org/pubs/poverty/Besharov%20Call%20Eradicate%20Poverty.pdf>

101. HERBERT STEIN, WASHINGTON BEDTIME STORIES: THE POLITICS OF MONEY AND JOBS 179 (1986).

102. THOMAS HOBBS, LEVIATHAN 139 (1904).